

## **B. J. Mark McWatters and Paul S. Atkins**

We concur with the issuance of the January report and offer additional observations below. We thank the Panel for incorporating suggestions offered during the drafting process.

### **1. Executive Summary**

We offer the following summary of our analysis:

- Treasury should request that each TARP recipient submit a formal exit strategy and update such strategy each calendar quarter. Treasury should also provide the Panel with its written assessment of the exit strategies and updates submitted by the TARP recipients.
- In order to expedite the swift metamorphosis of many TARP recipients from insolvent to investment grade, the institutions were arguably subsidized through government-sponsored purchases of mortgage-backed securities and by the all but unlimited investment of (and commitment to invest) public funds in Fannie Mae, Freddie Mac and AIG. One may argue that the government has created without meaningful public debate or analysis a series of “bad banks” within the Federal Reserve, Treasury, Fannie Mae, Freddie Mac, and AIG to accomplish what TARP alone failed to achieve. These “bad banks” or, perhaps, “debt consolidation entities” operate by *actually* and *virtually* removing toxic assets from the books of TARP recipients and other holders and issuers. The Federal Reserve and Treasury have *actually* removed up to \$1 trillion of troubled assets from the books of TARP recipients and other holders and issuers through outright purchases. The Federal Reserve and Treasury have also *virtually* removed additional troubled assets from the books of TARP recipients and other holders and issuers by propping up the market values of such assets and maintaining historically low mortgage rates.
- A question arises as to whether the termination of the AIG credit default swaps (CDSs) at par – that is, without any discount or haircut – constituted an inappropriate subsidy of the AIG counterparties – which included TARP recipients Goldman Sachs, Merrill Lynch and Bank of America – and necessitated the investment of additional TARP funds in AIG. Although then-FRBNY President Geithner denies that the payments by the Federal Reserve Bank of New York (FRBNY) constituted a “backdoor bailout” of the AIG counterparties, without any other explanation it is difficult to conclude that the FRBNY insisted that AIG terminate the CDSs other than as a mechanism to provide a direct – yet not particularly transparent – government-sponsored subsidy to the AIG counterparties. Without a better explanation of a straightforward business purpose for these transactions, the taxpayers may be best served by having Treasury seek rescission from the AIG counterparties, reversing cancellation of the CDS contracts and requiring the

counterparties to purchase the underlying collateralized debt obligations (CDOs) at their \$62.1 billion par value.

- Since Treasury is charged with protecting the interests of the taxpayers who funded the Home Affordable Modification Program (HAMP) and the other TARP programs, we recommend that Treasury's foreclosure mitigation efforts be structured so as to incorporate an effective exit strategy by allowing Treasury to participate in any subsequent appreciation in the home equity of any mortgagor whose loan is modified under HAMP or any other taxpayer subsidized program.

## **2. Required Submission of Proposed Exit Strategies by TARP Recipients**

One job of effective oversight is to assess the exit strategies proposed by TARP recipients and Treasury. In discharging this responsibility the Panel undertook in the January report to analyze (i) how each major TARP recipient plans to repay its TARP funds, (ii) how Treasury expects to recoup the TARP funds advanced to each major TARP recipient, and (iii) each of these strategies for transparency, effectiveness and taxpayer protection. The January report serves as an intermediate step in an on-going process, the ultimate effectiveness of which will depend upon the transparency and accountability of the disclosure provided by the TARP recipients and Treasury. The Panel cannot claim unique expertise regarding the wide array of financial institutions and non-financial institutions, such as Chrysler and General Motors, which have accepted TARP funds and, as such, must rely to a significant extent upon good faith submissions by TARP recipients and Treasury.

In our view, Treasury should request that each TARP recipient submit a formal exit strategy and update such strategy each calendar quarter. Treasury should also provide the Panel with its written assessment of the exit strategies and updates submitted by the TARP recipients. Because Treasury has stated that it has a "reluctant shareholder" investment strategy, the Panel and its staff, together with outside experts and advisors, should commit periodically to offer updated assessments of the proposed exit strategies for major TARP recipients as an addendum to the Panel's monthly reports. In our view, Treasury should exit each TARP investment as soon as possible,<sup>713</sup> and apply all proceeds received with respect to each TARP investment permanently to repay the national debt.<sup>714</sup>

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<sup>713</sup> It does not appear, however, that Treasury in fact is operating as a reluctant shareholder in all instances. The investment of yet another \$3.8 billion in GMAC – an apparently non-systemically significant financial institution – indicates a contrary strategy. Treasury's exit strategy with respect to GMAC remains a mystery. In addition, although the Panel in reports predating our membership on the Panel, has encouraged Treasury to hold its TARP investments in a series of trusts, as the January report acknowledges, such a structure is problematic and we cannot recommend it.

<sup>714</sup> Treasury has interpreted TARP as a "revolving facility" pursuant to which payments received under the program may be recycled and remitted to other TARP recipients. We disagree with this analysis and contend that all such payments should be applied *permanently* to repay the national debt.

### 3. The Repayment of TARP Funds

It is encouraging that several of the most significant recipients of TARP funds have been permitted by their regulators<sup>715</sup> to repay their TARP advances.<sup>716</sup> It is more satisfying that many of these recipients have funded their redemptions by successfully accessing the private capital markets. We remain optimistic that many – if not most – of these former TARP recipients will not return to business-as-usual, but will endeavor to operate with best practices in corporate governance and risk management guidelines and policies.

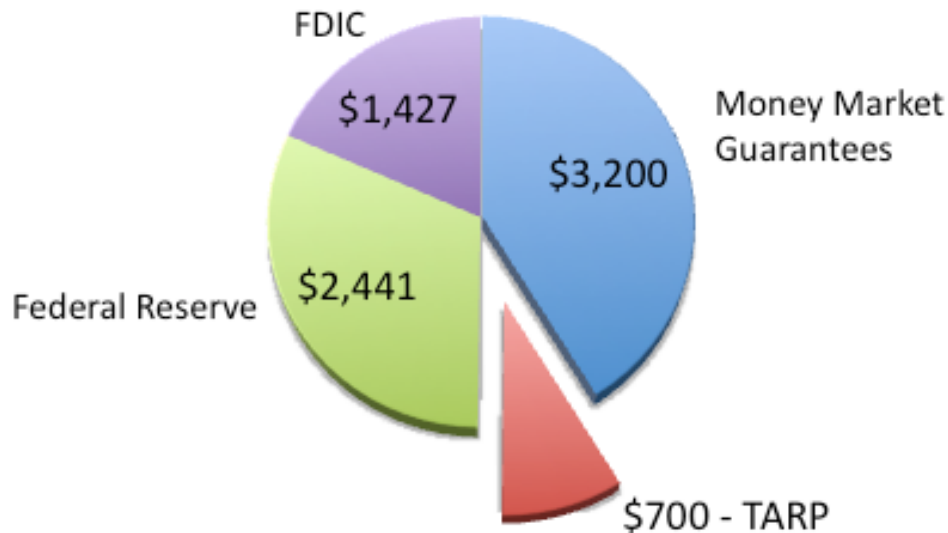
As the December Report discussed, TARP is only a small part of the total activity of the federal government to intervene in the financial markets in 2008, including larger government programs instituted by the Federal Reserve and the FDIC. TARP amounted to approximately 10 percent of the total exposure of the taxpayer.

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<sup>715</sup> We assume the applicable regulators have analyzed the many challenges facing financial institutions, including, without limitation, (i) rising credit card, consumer and home equity loan defaults, (ii) rising commercial real estate and private equity/leveraged buyout loan defaults, (iii) the loss of traditional profits centers due to recent regulatory changes, and (iv) the fall in loan demand from borrowers. See *Loan-Rate Differences are Challenges for Banks*, Wall Street Journal (Jan. 4, 2010) (online at [online.wsj.com/article/SB10001424052748704162104574630570328742070.html](http://online.wsj.com/article/SB10001424052748704162104574630570328742070.html)).

<sup>716</sup> Recipients of TARP funds appear eager to exit the program most likely because of the executive compensation restrictions as well as the general stigma associated with participation in the program and the risk that Congress and Treasury will mandate the application of additional adverse laws and regulations to such recipients.

## U.S. Financial Stabilization Exposures – May 2009 (\$billions)



Source: COP Report: *Stress Testing and Shoring Up Bank Capital*, 9 June 2009

Thus, we are troubled that some may view TARP as monochromatic whereby any institution that receives regulatory approval to redeem its TARP advances must necessarily be financially stable. This may not be the case. It is possible that but for the other programs and intervening events, many TARP recipients would not have been financially strong enough to receive regulatory clearance to exit TARP.

Financial institutions (and the automobile companies) have received many direct and indirect financial and regulatory subsidies, including:

- the support of TARP recipients by the Federal Reserve and Treasury with non-TARP sourced funds; and
- the settlement of AIG credit default swap obligations with certain TARP recipients at par value (*i.e.*, without any discount).

It is possible that these subsidies contributed to the alleged transformation of a group of essentially insolvent banks in 2008 into non-TARP dependent financial institutions by the end of 2009. These subsidies were delivered at significant cost, and the taxpayers – not the TARP recipients – will most likely ultimately bear those costs.<sup>717</sup>

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<sup>717</sup> It is also likely that a series of unintended consequences – such as the establishment of the United States government as the implicit/explicit guarantor of certain “too big to fail” institutions – will gain sounder footing from

We have heard much lately about the success of TARP and how the Capital Purchase Program – the original bailout program for approximately 700 financial institutions – may actually yield an overall net profit. This assessment appears premature and inappropriate. The final operating results of TARP should not be tallied without including the costs of the other subsidies afforded TARP recipients by the Federal Reserve, Treasury, Fannie Mae, Freddie Mac, and AIG (channeling Federal Reserve money).

**a. Support by the Federal Reserve and Treasury of TARP Recipients**

Fannie Mae and Freddie Mac together own or guarantee approximately \$5.5 trillion of the \$11.8 trillion in U.S. residential mortgage debt and financed as much as 75 percent of new U.S. mortgages during 2009.<sup>718</sup> On December 24, 2009, Treasury announced that it would provide an *unlimited* amount of additional assistance to the two government-sponsored enterprises (GSEs) as required over the next three years.<sup>719</sup> Treasury apparently took this action out of concern that the \$400 billion of support that it previously committed to the GSEs could prove insufficient. Additional assistance by Treasury will also allow the GSEs to honor their mortgaged-backed securities (MBS) guarantee obligations and to absorb further losses from the modification or write down of distressed mortgage loans.<sup>720</sup> Treasury also revised upwards to \$900 billion the cap<sup>721</sup> on the retained mortgage portfolio of each of the GSEs which means the GSEs will not be forced to sell MBS into a distressed market just as the Federal Reserve is preparing to end its program to purchase up to \$1.25 trillion of MBS.<sup>722</sup> The increased

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these investments. We do not support the recently announced proposal to levy a special tax, fee or assessment against financial institutions. Such a levy could impede lending in an already tight credit market.

<sup>718</sup> Dawn Kopecki, *Mortgage Anxieties Mean Limbo for Fannie and Freddie (Update 2)*, Bloomberg (Dec. 28, 2009) (online at [www.bloomberg.com/apps/news?pid=newsarchive&sid=aLEn75100iNg#](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aLEn75100iNg#)).

<sup>719</sup> U.S. Department of the Treasury, *Treasury Issues Update on Status of Support for Housing Programs* (Dec. 24, 2009) (online at [www.treasury.gov/press/releases/2009122415345924543.htm](http://www.treasury.gov/press/releases/2009122415345924543.htm)).

<sup>720</sup> Nick Timiraos, *Questions Surround Fannie, Freddie*, Wall Street Journal (Dec. 30, 2009) (online at [online.wsj.com/article/SB20001424052748704234304574626630520798314.html#mod=todays\\_us\\_money\\_and\\_investing](http://online.wsj.com/article/SB20001424052748704234304574626630520798314.html#mod=todays_us_money_and_investing)).

<sup>721</sup> The revised number should not be viewed as a “cap” since Treasury may again elect to increase the amount of retained MBS.

<sup>722</sup> Nick Timiraos, *Questions Surround Fannie, Freddie*, Wall Street Journal (Dec. 30, 2009) (online at [online.wsj.com/article/SB20001424052748704234304574626630520798314.html#mod=todays\\_us\\_money\\_and\\_investing](http://online.wsj.com/article/SB20001424052748704234304574626630520798314.html#mod=todays_us_money_and_investing)).

“The relaxed portfolio limits calmed investor worries that Fannie and Freddie would be forced to sell some of their mortgage holdings just as the Federal Reserve was preparing to wind down its purchases of mortgage-backed securities next spring. The Federal Reserve’s commitment to buy up to \$1.25 trillion has helped to keep mortgage rates near record lows; without that support some economists have said that could rise to 6% by the end of 2010.

Others said the new flexibility means that Fannie and Freddie could replace the Federal Reserve as a big buyer of mortgage-backed securities, especially if weak demand for mortgage-backed securities from private investors drives rates higher.”

commitment and revised cap enhance the likelihood that the GSEs will undertake to make “large-scale” purchases of distressed MBS for which they provided a guarantee.<sup>723</sup> Presumably, the GSEs may make such purchases from TARP recipients and other holders and issuers, and it will be interesting to note how the GSEs elect to employ the proceeds of this unlimited facility.

As reflected on its November 25, 2009 balance sheet, the Federal Reserve System holds \$155 billion face-value federal agency debt securities representing the direct obligations of Fannie Mae, Freddie Mac and the Federal Home Loan Banks, and \$852 billion of face-value MBS representing securities guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae. Since November 26, 2008, the Federal Reserve has increased its holdings of federal agency debt securities by \$143 billion, and the \$852 billion of MBS is entirely new since that date.<sup>724</sup> In addition, Treasury anticipates that as of December 31, 2009, it will have purchased \$220 billion of GSE-guaranteed MBS under the Housing and Economic Recovery Act of 2008 (HERA).<sup>725</sup>

It does not seem unreasonable to conclude that the actions of Treasury and the Federal Reserve in support of the MBS market and the GSEs also offered material assistance to many TARP recipients and expedited the exit of some recipients from the TARP.<sup>726</sup> By directly and

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<sup>723</sup> Jody Chenn, *Fannie Changes Clear Way for ‘Large-Scale’ Buyouts (Update 1)*, Bloomberg (Dec. 28, 2009) (online at [www.bloomberg.com/apps/news?pid=newsarchive&sid=aA7QrMCZHhRs#](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aA7QrMCZHhRs#)).

<sup>724</sup> Board of Governors of the Federal Reserve System, *Federal Reserve System Monthly Report on Credit and Liquidity Programs and Balance Sheet* (Dec. 2009) (online at [federalreserve.gov/monetarypolicy/files/monthlyclbsreport200912.pdf](http://federalreserve.gov/monetarypolicy/files/monthlyclbsreport200912.pdf)).

<sup>725</sup> U.S. Department of the Treasury, *Treasury Issues Update on Status of Support for Housing Programs* (Dec. 24, 2009) (online at [www.treasury.gov/press/releases/2009122415345924543.htm](http://www.treasury.gov/press/releases/2009122415345924543.htm)).

<sup>726</sup> This is not to say that the overarching purposes and mechanics of the Treasury and Federal Reserve programs are necessarily transparent. A number of questions – without limitation – are presented.

- What is the authority for Treasury’s unlimited assistance to the GSEs?
- Will the GSEs continue to use funds contributed by Treasury to guarantee the MBS purchased by the Federal Reserve?
- If so, are the taxpayers – through Treasury’s recently announced unlimited capital commitment to the GSEs – in effect bailing out the Federal Reserve for its efforts to create a liquid one-buyer market for MBS?
- Is one of the principal purposes of these circular purchases, capital infusions and guarantee payments simply to remove MBS from the books of TARP recipients (the original purpose of TARP) and other holders and issuers at favorable prices to the sellers?
- Is the Federal Reserve in effect bailing out TARP recipients and other holders and issuers of MBS?
- If so, will this action also placate foreign sovereigns and other holders and issuers that acquired GSE guaranteed MBS with the understanding that it was full faith and credit paper of the United States government?
- Have the purchases of MBS by the Federal Reserve coupled with the unlimited assistance from Treasury converted the implicit guarantee into an explicit guarantee of the GSEs by the United States government?
- If so, under what authority was such action taken?

indirectly (through the GSEs) funding the acquisition of MBS<sup>727</sup> from TARP recipients and other holders and issuers, Treasury and the Federal Reserve added liquidity to an all but frozen MBS market and no doubt enhanced the trading value of such securities. It is difficult to imagine that the Federal Reserve's public commitment to purchase up to \$1.25 trillion of MBS did not materially move the market and permit holders of MBS – including TARP recipients – to liquidate their investments at more favorable pricing. Even if the Federal Reserve ends its program to purchase MBS within the next few months<sup>728</sup> the GSEs could potentially pick up the slack by funding the acquisition of MBS through Treasury's recently announced expansion of its commitment to the GSEs. Further, by funding Fannie Mae's and Freddie Mac's performance of their MBS guarantee obligations, Treasury has directly supported the MBS market and, as such,

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- Has the Federal Reserve or Treasury purchased any MBS from any TARP recipient or other holder or issuer for consideration in excess of the then existing market value?
  - If so, under what authority was such action taken?

<sup>727</sup> To the extent Treasury or the Federal Reserve purchased MBS from TARP recipients for consideration in excess of market value, it is possible that some or all of the spread should be classified as a subsidy--without an offsetting additional reimbursement obligation – for the benefit of the selling TARP recipients. We question whether many TARP recipients would have sold a material portion of their MBS portfolios for less than the original purchase price paid for the securities due to the adverse effect the recognition of any resulting losses would have had on their required capital ratios. In addition, these transactions would have provided lower “marks” for valuation purposes, which could have had significant adverse balance sheet and income statement effects under FAS 157. Thus, the revision of the mark-to-market accounting rules noted below in the text may have also encouraged TARP holders to defer any sales of MBS for consideration less than their original purchase price. In addition to the cash infusion generated from the sale of illiquid MBS at favorable prices, the selling TARP recipients may have been able to book trading profits from the MBS dispositions and it is possible that some TARP recipients generated material trading gains by purchasing distressed MBS at well below par and selling the securities to Treasury or the Federal Reserve at or near par. These transactions would have bolstered the recipient's capital and expedited its exit from TARP.

The quantification of any such subsidy is not free from doubt since each MBS purchased by Treasury or the Federal Reserve apparently carried a GSE guarantee and presumably would have been paid pursuant to the terms of the guarantee contract assuming the guarantor remained solvent. Nevertheless, GSE guaranteed MBS presumably may trade below par if the guarantee obligation has not been triggered (or has only been partially triggered) and the disposition of any such MBS by a TARP recipient for consideration in excess of its prevailing market price may in certain instances be viewed as a subsidy to the selling recipient. The recognition of significant subsidies would have improved the financial position and operating results of TARP recipients and assisted their exit from the program. The cost of providing such subsidies to the TARP recipients will be borne by the taxpayers and not the recipients.

<sup>728</sup> *Fed may re-enter MBS market later in 2010-Market News*, Reuters (Jan. 5, 2010) (online at [www.reuters.com/article/idUSN0530695520100105?type=marketsNews](http://www.reuters.com/article/idUSN0530695520100105?type=marketsNews)):

“The Federal Reserve is discussing re-entering the mortgage-backed securities market later this year if its buying power is needed to hold down interest rates, Market News said on Tuesday in a story citing Fed officials.

The \$5 trillion agency mortgage-backed securities market may weaken when last year's biggest buyer, the Federal Reserve, ends its \$1.25 trillion agency MBS purchasing program at the end of the first quarter of 2010.”

*See also, Fed Minutes Show Division on Emergency Steps*, New York Times (Jan. 6, 2010) (online at [www.nytimes.com/2010/01/07/business/07fed.html?hp](http://www.nytimes.com/2010/01/07/business/07fed.html?hp)); *See also, Fed Plan to Stop Buying Mortgages Feeds Recovery Worries*, Wall Street Journal (Jan. 8, 2010) (online at [online.wsj.com/article/SB126291088200220743.html](http://online.wsj.com/article/SB126291088200220743.html)).

quite likely improved the net worth of many TARP recipients. Similarly, by purchasing MBS and GSE-issued mortgage bonds, the Federal Reserve has kept mortgage rates near historic lows,<sup>729</sup> thereby facilitating mortgage loan originations and refinancings and lessening the default rate on existing adjustable rate mortgage loans – all of which have benefited many TARP recipients.

In order to expedite the swift metamorphosis of many TARP recipients from insolvent to investment grade, the institutions were arguably subsidized through government-sponsored purchases of MBS and by the all but unlimited investment of (and commitment to invest) public funds in Fannie Mae, Freddie Mac and AIG. One may argue that the government has created without meaningful public debate or analysis a series of “bad banks” within the Federal Reserve, Treasury, Fannie Mae, Freddie Mac and AIG<sup>730</sup> to accomplish what TARP alone failed to achieve. These “bad banks” or, perhaps, “debt consolidation entities” operate by *actually* and *virtually* removing toxic assets from the books of TARP recipients and other holders and issuers. The Federal Reserve and Treasury have *actually* removed up to \$1 trillion of troubled assets from the books of TARP recipients and other holders and issuers through outright purchases.<sup>731</sup> The Federal Reserve and Treasury have also *virtually* removed additional troubled assets from the books of TARP recipients and other holders and issuers by propping up the market values of such assets and maintaining historically low mortgage rates.

Although Treasury and the Federal Reserve have arguably bolstered the net worth of many TARP recipients by purchasing MBS and investing in the two GSEs, much of the risk associated with Treasury’s and the Federal Reserve’s investments will fall to the taxpayers even though substantial benefits may inure to many TARP recipients. Such actions by Treasury and the Federal Reserve have all but enshrined the “implicit guarantee” of the United States government with respect to institutions that are deemed “too big or too interconnected to fail”

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<sup>729</sup> Although the purchases have reduced the cost of capital of the GSEs and lowered mortgage rates, some analysts fear that the withdrawal of Federal Reserve support for the GSEs will lead to an “asset collapse” while others note that such concerns are “overblown.” See *Mortgage Anxieties Mean Limbo for Fannie and Freddie (Update 2)*, Bloomberg (Dec. 28, 2009) (online at [www.bloomberg.com/apps/news?pid=newsarchive&sid=aLEn75100iNg#](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aLEn75100iNg#)); See also, *Mortgage Bond Rally May End, Rates Rise as Fed Stops Purchases*, Bloomberg (Dec. 31, 2009) (online at [www.bloomberg.com/apps/news?pid=20601087&sid=aukqYVzx6x3w&pos=4](http://www.bloomberg.com/apps/news?pid=20601087&sid=aukqYVzx6x3w&pos=4)).

<sup>730</sup> It is our understanding that many of the distressed assets of AIG are housed in a group of special purpose vehicles with the common name “Maiden Lane LLC.”

<sup>731</sup> Treasury anticipates that it will have purchased approximately \$220 billion face value of mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae by December 31, 2009, and the Federal Reserve’s November 25, 2009 balance sheet discloses the purchase of \$852 billion face value of mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae. See U.S. Department of the Treasury, *Treasury Issues Update on Status of Support for Housing Programs* (Dec. 24, 2009) (online at [www.treasury.gov/press/releases/2009122415345924543.htm](http://www.treasury.gov/press/releases/2009122415345924543.htm)); See also, Board of Governors of the Federal Reserve System, *Federal Reserve System Monthly Report on Credit and Liquidity Programs and Balance Sheet* (Dec. 2009) (online at [www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport200912.pdf](http://www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport200912.pdf)).



and may have intentionally or inadvertently subsidized the early exit from TARP of many recipients at an increasing cost of the taxpayers.

## **b. AIG and Credit Default Swap Payments**

On November 17, 2009, the Special Inspector General for TARP (SIGTARP) issued a report addressing the termination of certain AIG CDSs at par (SIGTARP Report).<sup>732</sup> In order to close out the AIG CDSs the FRBNY remitted \$27.1 billion to the AIG counterparties (CPs) in return for \$62.1 billion of face value CDOs held by the CPs.<sup>733</sup> The CPs were also permitted to retain \$35 billion of cash collateral previously pledged by AIG pursuant to the CDSs. The CPs – which included TARP recipients Goldman Sachs, Merrill Lynch and Bank of America – were paid the full face value of their respective CDOs and the FRBNY failed in its efforts to receive a discount in payment from any CP.<sup>734</sup>

A question arises as to whether the termination of the CDSs at par – that is, without any discount or haircut – constituted an inappropriate subsidy of the CPs and necessitated the investment of additional TARP funds in AIG. According to the SIGTARP Report, the CPs refused to accept a discounted payment and terminate the CDSs for less than par because (i) the collateral previously posted under the CDS contracts (\$35 billion) plus the then fair market value of the CDOs (\$27.1 billion) equaled the full face value of the CDOs (\$62.1 billion), (ii) the United States government had clearly signaled that it would not permit AIG to fail and, therefore, the CDSs would be honored in full, (iii) certain CPs had hedged against a default by AIG under the CDSs, and (iv) the CPs were entitled to par value payments pursuant to the CDS contracts.<sup>735</sup> Although the FRBNY apparently asked the CPs to accept a discounted payment for the settlement of the CDSs, their efforts ultimately proved unsuccessful.

These justifications proffered by the CPs, and accepted by the FRBNY, are not compelling. If the CPs believed that the United States government would not permit AIG to fail, then why did the FRBNY insist on terminating the CDSs? If the CPs were confident that AIG – or the FRBNY in its absence – would continue to post collateral if the fair market value of the CDOs declined or that the CDOs could be sold for their then market value if AIG collapsed, then

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<sup>732</sup> Office of the Special Inspector General for the Troubled Asset Relief Program, *Factors Affecting Efforts to Limit Payments to AIG Counterparties* (Nov. 17, 2009) (online at [www.sig tarp.gov/reports/audit/2009/Factors\\_Affecting\\_Efforts\\_to\\_Limit\\_Payments\\_to\\_AIG\\_Counterparties.pdf](http://www.sig tarp.gov/reports/audit/2009/Factors_Affecting_Efforts_to_Limit_Payments_to_AIG_Counterparties.pdf)).

<sup>733</sup> Each AIG CDS was structured with the applicable CP based upon a unique set of facts. The noted description is, by necessity, simplified.

<sup>734</sup> The aggregate face amount of the underlying CDOs equaled \$62.1 billion and the CPs received \$27.1 billion from the FRBNY and were permitted to retain \$35 billion of cash collateral previously pledged under the CDS contracts. *Id.*

<sup>735</sup> Office of the Special Inspector General for the Troubled Asset Relief Program, *Factors Affecting Efforts to Limit Payments to AIG Counterparties*, at 15 (Nov. 17, 2009) (online at [www.sig tarp.gov/reports/audit/2009/Factors\\_Affecting\\_Efforts\\_to\\_Limit\\_Payments\\_to\\_AIG\\_Counterparties.pdf](http://www.sig tarp.gov/reports/audit/2009/Factors_Affecting_Efforts_to_Limit_Payments_to_AIG_Counterparties.pdf)).

why not let the CPs assume that risk? If the CPs believed that their third-party hedges against an AIG default would be honored in full, then (again) why not let the CPs assume that risk? Although the SIGTARP Report notes that then-FRBNY President Geithner denies that the payments by the FRBNY constituted a “backdoor bailout” of the CPs,<sup>736</sup> without any other explanation it is difficult to conclude that the FRBNY insisted that AIG terminate the CDSs other than as a mechanism to provide a direct – yet not particularly transparent – government-sponsored subsidy to the CPs.<sup>737</sup>

Even if the FRBNY did not intend for the termination of the CDSs to serve as a government-sponsored subsidy of the CPs, why did the FRBNY fail to negotiate material discounts with each CP? Although the CPs may have believed that (i) the United States government would not let AIG fail, (ii) AIG – or the FRBNY – would continue to post collateral under the CDS contracts or that the CDOs could be sold for their then market value if AIG collapsed, and (iii) their third-party hedges would be honored in full, such assumptions were by no means free from doubt. All doubt was resolved, however, in favor of the CPs upon their receipt of cash payments from the FRBNY for the full par value of the CDOs. It seems that the negation of these risks should have merited the termination of the CDS contracts at a material discount to par value.

In addition, other justifications exist for discounting the payments remitted by the FRBNY to the CPs. Prior to the termination of the CDSs, the CPs held cash collateral of \$35 billion. Yet, after the termination of the CDSs, the CPs held actual cash in the same amount. The transformation of cash collateral into actual cash must have been of some benefit to the CPs.<sup>738</sup> Further, prior to the termination of the CDSs, the CPs held CDOs with a (falling) market value of \$27.1 billion, but after the termination of the CDSs, the CPs held actual cash in the same amount.<sup>739</sup> In effect, the FRBNY permitted – if not directly encouraged – the CPs to convert illiquid cash collateral and illiquid CDOs into \$62.1 billion of actual cash. Trading cash collateral and CDOs with a problematic market value for cash during a world-wide liquidity crunch must have been of substantial benefit to the CPs. Why was the FRBNY unable to terminate the CDSs at a material discount to par value? Why did the FRBNY not insist on these

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<sup>736</sup> Office of the Special Inspector General for the Troubled Asset Relief Program, *Factors Affecting Efforts to Limit Payments to AIG Counterparties*, at 30 (Nov. 17, 2009) (online at [www.sig tarp.gov/reports/audit/2009/Factors\\_Affecting\\_Efforts\\_to\\_Limit\\_Payments\\_to\\_AIG\\_Counterparties.pdf](http://www.sig tarp.gov/reports/audit/2009/Factors_Affecting_Efforts_to_Limit_Payments_to_AIG_Counterparties.pdf)).

<sup>737</sup> Is it likely that the market value of the referenced CDOs would have dropped from \$27.1 billion to zero and necessitated that AIG post additional collateral of \$27.1 billion? By terminating the CDS contracts at par, the FRBNY effectively assumed that the market value of the CDOs would drop to zero within the very near term.

<sup>738</sup> This assumes that posted collateral under these transactions was encumbered by contractual and legal restrictions.

<sup>739</sup> At the time the FRBNY financed the termination of the AIG CDSs, the CDO market was illiquid – if not frozen – and it is doubtful that lenders would have accepted CDOs as collateral without the imposition of substantial discounts to their then significantly depressed market values.

discounts? Again, the inescapable conclusion, without other facts, seems to be that this was a direct government-sponsored subsidy to the CPs.

It is unlikely that the FRBNY (or the United States government) has a basis to seek to unwind the termination of the CDSs or compel the CPs to promptly remit a suitable discount to the FRBNY. It appears that the CPs – including several TARP recipients – received another taxpayer subsidy for which they hold no reimbursement obligation. Without this substantial subsidy, it is possible that at least some of the CPs would not have been permitted by their regulators to exit the TARP program on an expedited basis. We recommend that the Panel investigate this matter in its upcoming report on AIG. Without a better explanation of a straightforward business purpose for these transactions, the taxpayers nevertheless may be best served by having Treasury seek rescission from the CPs, reversing cancellation of the CDS contracts and requiring the CPs to purchase the underlying CDOs at their \$62.1 billion par value.

#### **4. Exit Strategy from HAMP and Other Foreclosure Mitigation Programs**

The TARP-funded HAMP program carries a 100 percent subsidy rate according to the General Accounting Office.<sup>740</sup> This means that the United States government will recover *none* of the \$50 billion of taxpayer sourced TARP funds invested in the HAMP foreclosure mitigation program.<sup>741</sup> The projected shortfall will become more burdensome to the taxpayers as Treasury contemplates expanding HAMP or introducing additional programs targeted at modifying or refinancing distressed home mortgage loans. Since Treasury is charged with protecting the interests of the taxpayers who funded HAMP and the other TARP programs, we recommend that Treasury's foreclosure mitigation efforts be structured so as to incorporate an effective exit strategy by allowing Treasury to participate in any subsequent appreciation in the home equity of any mortgagor whose loan is modified under HAMP or any other taxpayer subsidized program.<sup>742</sup> In order to encourage the participation of mortgage lenders in Treasury's foreclosure mitigation efforts, such lenders should also be granted the right – subordinate to the right granted Treasury – to participate in any subsequent equity appreciation. The incorporation of an equity participation right may be achieved by the filing of a one-page document in the local real estate property records when the applicable home mortgage loan is modified. The mechanics of such a feature may be illustrated by the following example of a typical home mortgage loan modification.

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<sup>740</sup> Government Accountability Office, *Financial Audit: Office of Financial Stability (Troubled Asset Relief Program) Fiscal Year 2009 Financial Statements* (Dec. 2009) (online at [www.gao.gov/new.items/d10301.pdf](http://www.gao.gov/new.items/d10301.pdf)).

<sup>741</sup> Congressional Budget Office, *The Troubled Asset Relief Program: Report on Transactions Through June 17, 2009* (June 2009) (online at [www.cbo.gov/ftpdocs/100xx/doc10056/06-29-TARP.pdf](http://www.cbo.gov/ftpdocs/100xx/doc10056/06-29-TARP.pdf)).

<sup>742</sup> Congressional Oversight Panel, *Taking Stock: What Has the Troubled Asset Relief Program Achieved?*, Additional views of former panelist Congressman Jeb Hensarling (Dec. 9, 2009) (online at [cop.senate.gov/documents/cop-120909-report-hensarling.pdf](http://cop.senate.gov/documents/cop-120909-report-hensarling.pdf)).

Assume a homeowner borrows \$200,000 and purchases a residence in the same amount.<sup>743</sup> The home subsequently declines in value to \$175,000 and the homeowner and the mortgage lender agree to restructure the loan under a TARP-sponsored foreclosure mitigation program pursuant to which the outstanding principal balance of the loan is reduced to \$175,000 and Treasury advances \$10,000 in support of the restructure. Immediately after the modification the mortgage lender has suffered a \$25,000<sup>744</sup> economic loss and Treasury has advanced \$10,000 of TARP funds. If the homeowner subsequently sells the residence for \$225,000, the \$50,000 of realized equity proceeds<sup>745</sup> will be allocated in accordance with the following waterfall – the first \$10,000<sup>746</sup> is remitted to reimburse Treasury for the TARP funds advanced under the foreclosure mitigation program; the next \$25,000<sup>747</sup> is remitted to the mortgage lender to cover its \$25,000 economic loss; and the balance of \$15,000 is paid to the homeowner.

Prior to the repayment of all funds advanced by Treasury and the economic loss suffered by the mortgage lender the homeowner should not be permitted to borrow against any appreciation in the net equity value of the mortgaged property unless the proceeds are applied in accordance with the waterfall noted above. That is, instead of selling the residence for \$225,000 as assumed in the foregoing example, the homeowner should be permitted to borrow against any net equity in the residence, provided \$10,000 is remitted to Treasury and \$25,000 is paid to the mortgage holder prior to the homeowner retaining any such proceeds.<sup>748</sup> Such flexibility allows the homeowner to cash out the interests of Treasury and the mortgage lender without selling the residence securing the mortgage loan. The modified loan documents should also permit the

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<sup>743</sup> These facts illustrate the zero (\$0.00) down-payment financings that were more common a few years ago.

<sup>744</sup> The \$25,000 loss equals the \$200,000 principal balance of the original loan, less the \$175,000 principal balance of the modified loan. The example does not consider the consequences of modifying the interest rate on the loan.

<sup>745</sup> The \$50,000 of realized equity proceeds equals the \$225,000 sales price of the residence, less the \$175,000 outstanding balance of the modified loan. The example makes certain simplifying assumptions such as the absence of transaction and closing fees and expenses.

<sup>746</sup> In order to more appropriately protect the taxpayers, the \$10,000 advanced under the TARP sponsored foreclosure mitigation program should accrue interest at an objective and transparent rate of interest. For example, if the 30-year fixed rate of interest on mortgage loans equals five-percent when the mortgage loan is modified, the \$10,000 advance should accrue interest at such a rate and Treasury should be reimbursed the aggregate accrued amount upon realization of the equity proceeds. If at such time \$2,500 of interest has accrued, Treasury should be reimbursed \$12,500 (\$10,000 originally advanced, plus \$2,500 of accrued interest) instead of only the \$10,000 of TARP proceeds originally advanced.

<sup>747</sup> The mortgage lender may also argue that its \$25,000 loss should accrue interest in the same manner as provided Treasury. In such event, the mortgage lender would be entitled to recover \$25,000, plus accrued interest upon the realization of sufficient equity proceeds.

<sup>748</sup> Prudent underwriting standards should apply to all such home equity loans.

homeowner to repay Treasury and the mortgage lender from other sources such as personal savings or the disposition of other assets.<sup>749</sup>

We also recommend that to the extent permitted by applicable law, Treasury should structure all mortgage loan modifications and refinancings under HAMP and any other foreclosure mitigation programs as recourse obligations to the homeowners. If the loans are structured as non-recourse obligations, under state law or otherwise, the homeowners may have a diminished incentive to repay Treasury the funds advanced under TARP.<sup>750</sup>

In our view, the incorporation of these specifically targeted modifications into each TARP funded foreclosure mitigation program will enhance the possibility that Treasury will exit the programs at a reduced cost to the taxpayers.

## 5. Implicit Guarantees

The January report analyzes the difficulties that may arise when the United States government directly or indirectly undertakes to prevent certain systemically significant institutions from failing. Although the government does not generally guarantee the assets and obligations of private entities, its actions and policies may nevertheless send a clear message to the market that some institutions are simply too big, or too interconnected, to fail. Once the government adopts such a policy it is difficult to know how and where to draw the line. With little public debate, automobile manufacturers were recently transformed into financial institutions so they could be bailed out with TARP funds and an array of arguably non-systemically significant institutions – such as GMAC<sup>751</sup> – received many billions of dollars of taxpayer funded subsidies. In its haste to restructure favored institutions, the government may assume the role of king maker – as was surely the case in the Chrysler and GM bankruptcies – and dictate a reorganization structure that arguably contravenes years of well-established commercial and corporate law precedent. The unintended consequences of these actions linger in the financial markets and legal community long after the offending transactions have closed and adversely – yet subtly – affect subsequent transactions that carry any inherent risk of future

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<sup>749</sup> Treasury may wish to structure its foreclosure mitigation efforts so as to encourage the early repayment of TARP funds by homeowners. Treasury, for example, could agree to a ten-percent discount or waive the accrual of interest on the TARP funds advanced if a homeowner repays such funds in full within three years following the restructuring. Any such incentives should appear reasonable to the taxpayers and should not negate the intent of the equity participation right. Mortgage lenders may also agree to similar incentives.

<sup>750</sup> Roger Lowenstein, *Walk Away From Your Home*, New York Times (Jan. 7, 2009) (online at [www.nytimes.com/2010/01/10/magazine/10FOB-wwln-t.html?hp](http://www.nytimes.com/2010/01/10/magazine/10FOB-wwln-t.html?hp)). The article implies that a recourse structure is of little benefit if the homeowner is otherwise judgment proof.

<sup>751</sup> Although Treasury indicates that GMAC was (again) saved so as to support its auto financing business, it also appears that substantial GMAC losses stem from speculation in the MBS market. It is unclear why GMAC – a putative auto finance company – chose to speculate in the MBS market. We recommend that the Panel investigate GMAC and the inherent ongoing subsidies that its taxpayer-supported operations afford to Chrysler and GM in contrast to their competitors.

governmental intervention. The uninitiated may question why two seemingly identical business transactions merit disparate risk-adjusted rates of return or why some transactions appear over-collateralized or inexplicably complicated. The costs of mitigating political risk in private sector business transactions are seldom quantified or even discussed outside the cadre of businesspersons and their advisors who structure, negotiate and close such transactions, yet such costs certainly exist and must be satisfied.

The resolution of the fundamental public policy issues arising from implicit guarantee and political risk should remain with Congress.